IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1948.

Nos. ~~834 - 835~~ 94-95

ERNEST A. JACKSON,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

HARRIS TRUST AND SAVINGS BANK, AS EXECUTOR (ESTATE OF ROBERT O. FARRELL, DECEASED),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

CARROLL J. LORD,
Attorney for Ernest A. Jackson, One of the Above Named Petitioners.

LELAND K. NEEVES,
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To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

Your Petitioners respectfully pray for writs of certiorari to review two judgments of the United States Court of Appeals for the Seventh Circuit which affirmed judgments of the Tax Court of the United States confirming deficiencies against Petitioners for income taxes for the calendar year 1941 in the amounts of $36,870.26 and $71,620.14, respectively. Because of the identity of issue in the two cases, Petitioners join in this petition.

OPINIONS BELOW.

The opinion of the Tax Court was promulgated on September 10, 1947. It is reported in 9 T. C. 307, and appears in the record at page 57.

The opinion below is reported in 172 F. (2d) 607, and appears in the record at page 90. In both the Tax Court and the court below a single opinion was promulgated in the two cases.

The judgments of the Tax Court were rendered on September 11, 1947. (R. 62-63.)

JURISDICTION.

The judgments below were rendered on February 17, 1949. (R. 95-96.) Petitions for rehearing were denied on March 16, 1949. (R. 97-98.)

The jurisdiction of this Court is invoked under Title 28, United States Code, Section 1254 (1).

QUESTIONS PRESENTED.

1. Whether the court below erred in holding that Article 1561 of Regulations 69 (1926) was a correct interpretation of the Revenue Act of 1926 and that carrying charges were properly chargeable under that Act to capital account.

2. Whether the expenditures here involved, namely, rent, taxes, interest, and financing charges, are carrying charges.

STATUTES AND REGULATIONS INVOLVED.

The applicable portions of the Revenue Acts of 1924, 1926, 1928 and 1932, together with the applicable portions of Regulations 65, 69, 74, and 77 are set out in the appendix.

SUMMARY STATEMENT OF THE MATTER INVOLVED.

The two cases involve the same issue. They were consolidated in the Tax Court for hearing and decision. (R. 1, 3.) They were heard in the court below upon a consolidated record. (R. 80.)

The sole issue in the two cases is as to whether a distribution to Petitioners in 1941 made by Wabash-Monroe Building Corporation, was from "earnings or profits" and taxable as a dividend, as contended by Respondent, or was from capital, and taxable merely as capital gain, as contended by Petitioners. The determination of this issue depends upon the amount of the "earnings or profits" of the corporation in 1941, and, under the stipulations upon which the cases were tried, turns upon whether certain items of rent, taxes, interest, and financing charges which were paid by the corporation in 1926 and 1927 and charged to "capital account", were properly so charged. Respondent contends that the items were properly charged to capital account under the authority of Article 1561 of Regulations 69 (1926); that all the items here involved are carrying charges within the meaning of that Regulation; and that in any event all the items were "capital" items properly chargeable to capital account within the meaning of

Section 202(b) of the 1926 Act, wholly apart, it is said, from the Regulation.

Petitioners contend that the items in question were not expenditures or items "properly chargeable to capital account" under the provisions of said Section 202(b); that, with the bare exception of the one item of Federal income tax paid with respect to the corporation's tax free covenant bonds, they were items of expense specifically required by Section 234(a) of the Act to be deducted in computing net income; that said Article 1561 is invalid in so far as it attempts to authorize the capitalization of carrying charges for the reason that said Article in such regard is in plain contravention of the statute; and finally that the items are not carrying charges at all.

The question as to whether the items are carrying charges arises not only with respect to the Revenue Acts prior to the Revenue Act of 1932 and with respect to Regulations 65, 69, and 74, but also arises with respect to the special wording of the 1932 and subsequent Revenue Acts which in terms permit the capitalization of carrying charges.

The facts were for the most part stipulated. (R. 28, 38.) Briefly, they are as follows:

Petitioner Ernest A. Jackson and the decedent, Robert O. Farrell, who owned, respectively, 45 per cent and 50 per cent of the outstanding stock of Wabash-Monroe Building Corporation, received a cash distribution from the corporation in 1941 in the amounts of $112,500 and $125,000, respectively. In their income tax returns for 1941 they reported the distribution as a return of capital upon the ground that for income tax accounting purposes the corporation at that time had no earnings or profits. Upon audit the deficiencies here in question were asserted on the ground that the corporation had earnings and profits

sufficient to constitute the distribution a taxable dividend. (R. 8, 19.)

Wabash-Monroe Building Corporation was organized in 1925 for the purpose of acquiring a lease on certain real estate in Chicago and for the purpose of erecting and operating a building thereon. The lease was for a period of 99 years, commencing September 1, 1925. The rent from March 1, 1926 to February 28, 1927 was $75,000, and from March 1, 1927 until the termination of the lease $120,000 per annum. (R. 21.) Lessee was required to pay the real estate taxes, (R. 42-44) and to commence the construction of a new building on the premises on or about April 1, 1926, and to complete the same within fourteen months thereafter. (R. 45.) In accordance with these requirements the corporation constructed a new building on the demised premises, and completed the same on or about June 30, 1927. (R. 29.)

During the construction period the corporation had no income other than interest on the unused portion of its construction funds. (R. 29.)

The cost of the building, as first reflected upon the corporation's books, was $2,505,907.83. (R. 29-31.) Later, upon audit, the examining agent reduced the cost of the building to $2,491,187.57 as of July 1, 1927. (R. 31.) The reduction of $14,720.27 is not in controversy.

Included in the above "cost" were the following items which had been expended by the corporation during the construction period (Stip. of Facts, Pars. 7. 9; R. 32-33):

Rent and interest—	
Ground rentals under 99 year lease paid to Estate of Leon Mandel for period of March 1, 1926 to June 30, 1927	$115,000.00(a)

Interest		
Paid on bonds and notes to June 30, 1927.....	$237.203.97	
Less—Interest income received on bank deposits and escrow funds of Wabash-Monroe Building Corporation.....	87,942.38	149,261.59(b)
Taxes		
Michigan state tax on bonds	155.00	
Illinois franchise tax...	500.00	
Real estate taxes paid which were required by ground lease.....	80,376.04	
Federal income tax on tax free covenant bonds of Wabash-Monroe Building Corporation	5,227.50	86,258.54(c)
Trustee fees to banks for services in acting as disbursing agents.....	8,285.42	
Compensation paid Ward Castle for financing services	25,000.00	33,285.42(d)

The above items aggregate $383,305.55.

From July 1, 1927 to July 1, 1937, depreciation was claimed and allowed for income tax purposes on the above mentioned building cost of $2,491,187.56. For the period from January 1, 1938, to November 30, 1941, depreciation was claimed and allowed for income tax purposes based on a building cost of $2,486,774.80. (Stip. of Facts, Par. 12; R. 34.) This reduction of cost of $4,412.70 (which is explained in Par. 11 of the Stipulation, R. 34) is not here in controversy.

No adjustment of the above building cost was ever

sought by the corporation for depreciation purposes excepting that with respect to its taxable year ended November 30, 1943, the corporation, in a protest filed with the Internal Revenue Agent in Charge at Chicago, proposed to decrease the cost of the building and to calculate depreciation for that year on the amount of the decreased cost further reduced by all depreciation allowed from July 1, 1927 to November 30, 1942. (Stip. of Facts, Par. 14; R. 34, 35.)

At a meeting held on November 19, 1941, the directors of the corporation directed a distribution to the stockholders on November 30th, to be made from "capital surplus." (R. 36.) The distribution was as follows:

Robert O. Farrell.....	$125,000
Ernest A. Jackson.....	115,000
Carroll J. Lord.....	12,500

It was stipulated that the corporation had no net earnings or profits available for dividends as a result of its operations from January 1 to November 30, 1941. (Stip. of Facts, Par. 19; R. 36.)

It was further stipulated (Stip. of Facts, Pars. 21, 22; R. 37) as follows:

"21. If, under the circumstances of this proceeding, the Court holds that items (a), (b), (c), and (d) of paragraphs 7 and 9 hereof were properly charged to building costs as distinguished from a charge against earnings and profits, it is agreed that the earnings and profits accumulated after February 28, 1913 of the Wabash-Monroe Building Corporation as at January 1, 1941 was $301,090.15.

"22. If under the circumstances of this proceeding, the Court holds that items (a), (b), (c) and (d) of paragraphs 7 and 9 hereof, or any of them, constitute proper charges against earnings and profits as distinguished from a charge to building costs, it is agreed that each of such items (a), (b), (c) and (d),

would constitute a pro tanto reduction of the aforesaid amount of accumulated earnings as at January 1, 1941 of $301,090.16."

All of the expenditures in question were made in 1926 and 1927. The court is in agreement with the parties hereto that the issue herein is to be determined by the law in effect in those years—which was the Revenue Act of 1926 and any valid Regulation thereunder. The determination of the issue is in no way controlled by the special wording of the 1932 Act. The court below resorted to that Act, merely as being a Congressional approval of the 1926 Regulation (R. 93), and as showing the Congressional intention, presumably with respect to the earlier Acts. (R. 94.)

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRITS OF CERTIORARI HEREIN PRAYED.

The court below has held (1) that Article 1561 of Regulation 69, purporting to authorize the capitalization of carrying charges, was a correct interpretation of the Revenue Act of 1926, and (2) that all the expenditures made by the corporation in 1926 and 1927 for rent, interest, taxes and financing charges, amounting to $383,305.33, being the items here involved, were carrying charges.

The result is, that, in accordance with paragraphs 21 and 22 of the Stipulation of Facts heretofore referred to, the accumulated earnings of Wabash-Monroe Building Corporation, as per the books, amounting, in 1941, to $301,090.15, are not to be reduced by any of the items in question, and the corporation accordingly had "earnings or profits" in 1941 sufficient in amount to constitute the distribution then made a taxable dividend.

1. The decision of the court below is in direct conflict with the decision upon the same matter of the Court of Appeals for the Fifth Circuit in *Central Real Estate Co.* v. *Commissioner*, 47 F. (2d) 1036, which held said Article 1561 to be invalid. The court there held that the Regulation was in plain contravention of the statute, which did not permit carrying charges to be capitalized, since the statute (section 234(a) of the Revenue Act of 1926) specifically provided for the deduction of interest and taxes in determining net income. The conflict between that decision and the decision below appears from the opinion below wherein it was said (R. 93):

> "In the light of our foregoing discussion, we cannot agree that the court [the Fifth Circuit in *Central*] did not hold the regulation invalid."

And further (R. 94):

> "It is true that while the Central Real Estate decision was rendered prior to the Act of 1932, it is apparent that its conclusion in regard to regulation 69 was a misinterpretation of Congressional intention."

Prior to the decisions below, the decision in *Central* had been uniformly accepted by the courts as correctly interpretive of all the Revenue Acts prior to the Revenue Act of 1932. We refer the court to the following decisions so accepting and following the decision in *Central:*

H. M. O. Lumber Co. v. *United States,* C. A. 6, 59 F. (2d) 907.

Queensboro Corp. v. *Commissioner,* C. A. 2, 134 F. (2d) 942.

Moran v. *United States,* Ct. Cl., 19 F. Supp. 557.

Southern Railway Co. v. *Commissioner,* 27 B. T. A. 673.

Great Northern Ry. Co. v. *Commissioner,* 30 B. T. A. 691.

Kentucky Natural Gas Corp. v. *Commissioner,* 47 B. T. A. 330.

Necessarily the decision below is in direct conflict with the last above mentioned decisions.

In *F. H. E. Oil Co.* v. *Commissioner,* 147 F. (2d) 1002, on rehearing 149 F. (2d) 238, on second rehearing, 150 F. (2d) 857, the court considered the validity of the long established regulation whereby a taxpayer is given the option either to capitalize drilling costs or to charge them to expense. The taxpayer there had elected to charge such costs to expense in computing net income. The deductions were disallowed by Respondent on the ground that such costs were essentially capital expenditures, and that the

Revenue Acts did not permit such expenditures to be deducted as items of expense. Respondent's position was sustained. In its first opinion the entire Regulation was held void on the ground that the tax laws did not permit capital expenditures to be deducted in computing net income. In its second opinion, while adhering to its views, expressed in its first decision, the court limited its decision to the cases immediately before it which involved drilling costs where the taxpayer was either seeking to retain an interest in property, or to enlarge or extend an existing interest. The court, however, pointed out that what made the Regulation even worse was the fact that it gave to the taxpayer an optional right to charge such drilling costs to capital or income as he might see fit.

The decision below is necessarily in conflict with the decision in the *Oil* case.

The conflict between the decision below and the decision in *Central* creates an impossible situation. Taxpayers in the utility field are especially affected by the decision below. Practically all utility companies, including railroads, for their own accounting purposes capitalize taxes and interest paid with respect to new construction, and have uniformly done so for a great many years. Such items are treated as elements of cost. Under certain circumstances the inclusion of such items as part of cost is required by other administrative agencies which regulate utility accounting. For example, it appeared in *Southern Railway Co.*, 27 B. T. A. 673, referred to above, that taxes and interest during construction were required by the Interstate Commerce Commission to be included in cost. Nevertheless they were excluded by Respondent and the Board in determining the income tax liabilities of the taxpayer. The Board there, after referring to the decision in *Central* and other like cases, quoted from *Kansas City Southern Ry.*

Co. v. *Commissioner*, C. A. 8, 52 F. (2d) 372, as follows (pp. 683-4):

> "Systems of accounting for railroads under the control of the Commission cannot interfere with the Government's system of taxation. The Commission has no power to direct how the revenue laws of the United States shall be interpreted, or by its orders provide standards to govern the taxing authorities."

Ever since the decision in *Central* came down, and in reliance thereon, Respondent has disallowed all such items as elements of cost and has held that all such items are deductible from income when incurred in accordance with the provisions of section 234(a) of the Revenue Act of 1926 and similar provisions of subsequent Revenue Acts and the Internal Revenue Code.

"Cost" is a controlling factor not only in determining depreciation and the like, but also in determining gain or loss in the event of the sale of the property, and particularly in determining abandonment losses. It is highly essential, both from the standpoint of the taxpayer as well as from the standpoint of the public revenue, that "cost" be determined correctly and in accord with our tax laws. Because of the decisions below, both taxpayers and the Government are confronted with two diametrically opposed decisions. Both cannot be right, and both cannot be given effect. The question is bound to come before others of the Federal courts, and, having to choose between the court below and *Central*, no matter what their choice may be, their decisions will only add to the conflict and confusion. Taxpayers in the utility field will undoubtedly want the decision below to stand, while at the same time the Government will be put to the necessity of making some fine drawn and unsubstantial distinctions if the effect of the decision below is to be avoided. In the nature of things, endless litigation is bound to ensue unless the present con-

flict is speedily and finally resolved by this Court. This Court, alone, can settle the question once and for all.

2. The decision below is in direct conflict with the great body of law applicable not only to the Revenue Acts prior to that of 1932, but to that Act and all of the later Acts up to the time of the 1942 amendments to the Code, to the effect, without exception, that interest on *new construction* is not a carrying charge, is not a capital item, and cannot be charged to capital account. Prior to the 1942 amendments, interest on new construction could no more be charged to capital account as constituting a carrying charge, or otherwise, under the special wording of the 1932 and subsequent Revenue Act, than it could be so charged under the purported authority of the 1924, 1926, and 1928 Regulations—assuming those Regulations to be valid. To the point that interest on new construction is not a carrying charge, and is not properly chargeable to capital account, we refer the Court to:

Columbia Theatre Co., 3 B. T. A. 622.
Spring Valley Water Co., 5 B. T. A. 660.
Eastern Rolling Mill Co., 5 B. T. A. 663.
Ottawa Park Realty Co., 5 B. T. A. 474.
Oswego and S. R. R. Co., C. C. A. 2, 29 F. (2d) 487, affirming 9 B. T. A. 904.
Moran v. *United States*, Ct. Cl., 19 F. Supp. 557.
Kentucky Natural Gas Corp. v. *Commissioner*, 47 B. T. A. 330.
Queensboro Corp. v. *Commissioner*, C. A. 2, 134 F. (2d) 942.

Other than the decisions herein, there are no decisions contrary to the holding of the above cases.

The decision below in this respect is extraordinary in its complete disregard of the heretofore established law. The court below not only cites no authority in support of its

view (there isn't any such authority, of course), but does not attempt even to discuss the question. Nor are the cases above cited even mentioned by the court below in its decision herein. The decision is even more extraordinary, and Respondent's position with respect to the interest item is even less understandable in view of the fact that he has explicitly stated by formal Regulation that interest on new construction was not properly chargeable to capital account prior to the 1942 amendments. (Reg. 103, Sec. 19.24-5, as added by T. D. 5251, March 27, 1943.) Cf. *Warner Mountains Lumber Co.*, 9 T. C. 1171, commencing at the bottom of page 1177, where the question of capitalizing interest was discussed at some length.

3. Apart from the interest question and the conflict between the decision below and the decisions cited above, it is of importance in the administration of our tax laws that this Court decide whether or not items of the kind here involved including especially interest on new construction, are or are not carrying charges. This is a further reason for granting certiorari herein. The question is of importance not only with respect to the Revenue Acts of 1924, 1926, and 1928 and the Regulations thereunder, but also with respect to the special wording of the 1932 and later Revenue Acts. The question is of large importance even under the 1942 amendments to the Code, which in Section 24(a)(7) authorized Respondent to provide by Regulation for the charging to capital account of "taxes and carrying charges." The court below has fallen into grave error in holding that the items here involved are carrying charges. From the standpoint of the public revenue, the Court's decision is fraught with extreme danger.

None of the Revenue Acts and none of the Regulations has ever purported to define the term "carrying charges."

Cf. *Warner Mountains Lumber Co.*, 9 T. C. 1171, at p. 1176. Nor has any court attempted such definition. In his brief in *Warner* (9 T. C. 1171) Respondent said:

> "Under the Revenue Act of 1932 taxes and other carrying charges on unimproved and unproductive property can be added to cost basis conditioned on the item being 'properly chargeable to capital account.' The query is then raised as to what items are 'properly chargeable to capital account.' The field here is very limited. It has always been held that such items are those which add to the value of the original investment. *The Queensboro Corporation, supra.* Taxes on unproductive property have been specifically added as an item which can always be chargeable to capital account. Section 113(b)(1)(A). It has also been held that interest paid on the purchase price of unproductive property can now be charged to capital account. Other than these two items the field of 'carrying charges properly chargeable to capital account' is very narrow, and it is difficult, if not impossible, to enumerate any other classes of 'carrying charges properly chargeable to capital account.' See *The Queensboro Corporation, supra.*"

The Tax Court in its decision herein, simply assumed that the items were carrying charges. (R. 57.) The court below, in its opinion, dismissed the question with the following statement (R. 94):

> "The petitioners also contend that the charges in question are not actually carrying charges within the meaning of capital expenditures. Under the facts in this case it will be sufficient to say that all the charges involved were incurred while the property was unproductive, and undoubtedly were assumed for the purpose of converting it into the productive state for which it was acquired."

We have found no decision on the point as to whether rent is a carrying charge, or whether there is a distinction

between rent paid under an ordinary short term lease and rent paid under a long term lease, as in the instant case, which involve a 99-year lease. Respondent relies on G. C. M. 11197, C. B. XII-1, 238, as his sole authority for contending that rent is a carrying charge. The only possible reason for saying that rent is a carrying charge is that the property itself is unproductive. But where the property is unproductive there would be no gross revenue from which the rent would be deducted, and hence whether rent is or is not deducted as an expense would not affect "net income." Obviously in such a case the public revenue is not harmed. Either the deduction or non-deduction of the rent would of itself be immaterial. But if rent is included as an element of cost the public revenue would be very much effected thereby. Depreciation allowances would be increased. The gain, if any, resulting from a subsequent sale of the property would be decreased, or the loss, if any, would be increased. And if the property were abandoned the loss, deductible in full, would likewise be enhanced. By adding rent, paid with respect to unproductive property, to cost, the taxpayer, through his depreciation allowance, would secure the full benefit of a rent deduction just as if it had been deducted in computing net income and the gross income were sufficient to absorb it.

Even in the present Regulations (Reg. 111, Sec. 29.24-5), adopted under the express authority of Section 24(a)(7) above, rent is not included as being a "carrying charge" which can be capitalized.

Taxes on unproductive property, when paid by the owner, are regarded as carrying charges. But, for income tax purposes, real estate taxes paid by a lessee for the lessor's account under the requirements of the lease are regarded not as taxes but as so much additional rent. (Art. 110, Reg. 65 (1924); Art. 111, Reg. 69 (1926); Art. 130, Reg. 74

(1928); Reg. 103, Sec. 19.23(a)-10; Reg. 111, Sec. 29.23(a)-10.) Taxes so paid would seem to be in the same category as the rent itself, and if rent is not a carrying charge, then taxes so paid by the lessee are likewise not carrying charges. As to the other taxes, the Michigan state tax on bonds ($155) and the Illinois franchise tax ($500) are clearly "taxes" required to be deducted under the express wording of Section 234(a) of the 1926 Act in computing net income. As to the Federal income tax paid by the corporation with respect to its tax free covenant bonds ($5,227.50), granting that such tax is not deductible in computing net income by virtue of the express provisions of Section 234(a)(3)(A), nevertheless the tax is still a tax and can in no event be said to be a "carrying charge" so far as the property itself is concerned. The result is that none of the taxes, including the real estate taxes, can be held to be carrying charges.

The financing charges, amounting to $33,285.42 (R. 33), would seem to be an ordinary expense of the business, deductible as such in computing net income. No more than the other items are the financing charges to be regarded as "carrying charges." Cf. *Moran* v. *United States,* Ct. Cls., 19 F. Supp. 557.

Conclusion.

Determination of "cost" is an ever present problem. "Cost" controls the amount of depreciation and the like which may be deducted in computing net income. "Cost" controls the determination of gain or loss upon a subsequent sale or exchange of the property, and controls the amount of loss which may be deducted upon abandonment. The determination of the elements constituting cost should therefore not be left in its present chaotic condition, which is the result of the decision below. While it is true that the question in the instant cases comes up in connection

with the determination of the "earnings or profits" of the corporation and therefore it is to Respondent's advantage to contend that the items here involved are carrying charges and were properly charged to capital account in 1926 and 1927 to the end that the accumulated earnings of the company as per the books should remain unchanged, and to the end that Petitioners be taxed upon the 1941 distribution as a dividend, nevertheless the necessity of a correct determination of "cost" is of much greater importance, certainly from the standpoint of the Treasury itself.

As late as his brief in the *Warner Mountains Lumber* case, heretofore referred to, Respondent was earnestly contending that the *Central Real Estate Co.* decision was correct, and that carrying charges could not be capitalized under any of the Revenue Acts prior to that of 1932. It is not readily apparent why Respondent at this late date, and so suddenly, has so radically changed his position in regard to the *Central* decision. Certainly the collection of the comparatively small amount of taxes from these Petitioners would not seem adequate ground for the change. It is no answer to say, as the court below said, that it had "no concern with alleged errors which he [Respondent] may have alleged to other courts." (R. 94-5.) The court is concerned, however, or should be concerned, with correctly deciding the issue before it. And, after all, Respondent's long acquiescence in the *Central Real Estate* decision, his persistent reliance thereon in determining the income tax liabilities of innumerable taxpayers, his repeated and unequivocal statements in other cases, and to other courts, that the decision in *Central* was correct, the lapse of more than seventeen years since *Central* was decided, its acceptance by taxpayers and by the courts generally, together with the obvious soundness of the decision itself, should have induced the court below to give pause before it overturned the *Central* decision.

Petitioners respectfully urge that the writs herein prayed be granted, to the end that the existing confusion be cleared up, and the conflict in decisions resolved.

Respectfully submitted,

CARROLL J. LORD,
Attorney for Ernest A. Jackson, One of the Above Named Petitioners.

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Attorneys for Harris Trust and Savings Bank, as Executor (Estate of Robert O. Farrell, Deceased), One of the Above Named Petitioners.

APPENDIX.

Revenue Act of 1924.

Sec. 202. * * *

(b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account. * * *

Revenue Act of 1926.

Sec. 202. * * *

(b) In computing the amount of gain or loss under subdivision (a)—

(1) Proper adjustment shall be made for any expenditure or item of loss properly chargeable to capital account. * * *

Sec. 234. (a) In computing the net income of a corporation * * * there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * * and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

(2) All interest paid or accrued within the taxable year on its indebtedness. * * *

(3) Taxes paid or accrued within the taxable year except (A) income, war-profits, and excess-profits taxes imposed by the authority of the United States. * * *. In the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the tax-free covenant clause, shall be allowed, nor shall such tax be included in the gross income of the obligee. * * *

Revenue Act of 1928.

Sec. 111. *Determination of Amount of Gain or Loss.* • • •

(b) ADJUSTMENT OF BASIS—In computing the amount of gain or loss under subsection (a)—

(1) Proper adjustment shall be made for any expenditure, receipt, loss, or other item properly chargeable to capital account. • • •

Revenue Act of 1932.

Sec. 113. *Adjusted Basis for Determining Gain or Loss.* • • •

(b) ADJUSTED BASIS—• • •

(1) GENERAL RULE—Proper adjustment in respect of property shall in all cases be made—

(A) For expenditures, receipts, losses, or other items properly chargeable to capital account including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable or prior taxable years; • • •

Article 1561, Regulations 65 (1924).

• • • • • •

• • • In computing the amount of gain or loss, however, the cost or other basis of the property, must be increased by the cost of capital improvements and betterments made to the property since the basic date, and by carrying charges, such as taxes on unproductive property, • • •.

Article 1561, Regulations 69 (1926).

• • • • • •

• • • In computing the amount of gain or loss, however, the cost or other basis of property must be increased by the cost of capital improvements and betterments made to the property since the basic date, and by carrying charges, such as taxes on unproductive property. Where the taxpayer has elected to deduct carrying charges in computing net income, or

use such charges in determining his liability for filing returns of income for prior years, the cost or other basis may not be increased by such items in computing the gain or loss from the subsequent sale of the property. * * *

Article 561, Regulations 74 (1928).

* * * * *

* * * In computing the amount of gain or loss, however, the cost or other basis of the property shall be properly adjusted for any expenditure, receipt, loss, or other item properly chargeable to capital account, including the cost of improvements and betterments made to the property since the basic date and carrying charges, such as taxes on unproductive property. Where the taxpayer has elected to deduct carrying charges in computing net income, or use such charges in determining his liability for filing returns of income for prior years, the cost or other basis may not be increased by such items in computing the gain or loss from the subsequent sale of the property.

Article 605, Regulation 77 (1932).

* * * * *

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other items, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * * In the case of unimproved and unproductive real property, carrying charges, such as taxes and interest, which have not been taken as deductions by the taxpayer in determining net income for the taxable year, or a prior taxable year, are properly chargeable to capital account.

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CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 94

ERNEST A. JACKSON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 95

ROBERT O. FARRELL, DECEASED, HARRIS TRUST AND SAVINGS BANK, AS EXECUTOR, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 53-62) is reported at 9 T.C. 307. The opinion of the Court of Appeals (R. 90-95) is reported at 172 F. 2d 605.

JURISDICTION

The judgments of the Court of Appeals were entered on February 17, 1949 (R. 95-96). Peti-

tions for rehearing were filed on March 4, 1949, and were denied on March 16, 1949 (R. 96-98). A petition for writs of certiorari was filed on June 3, 1949. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

The underlying question in this case is whether a cash distribution by a corporation to the taxpayer-stockholders in 1941 was from the corporation's accumulated earnings and profits, and thus taxable as a dividend under Sections 22 (a) and 115 (a) of the Internal Revenue Code.

The answer to this question depends on whether a corporation, which incurred certain carrying charges in 1926 and 1927 to carry a building during its construction period when the property was unproductive, properly treated these expenditures as part of the cost of the building, as the court below held, or whether these expenditures should have been treated as current operating expenses when incurred, and charged to the earned surplus account, as the taxpayer-stockholders contend.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and regulations involved are set forth in the Appendix, *infra,* pp. 14-19.

STATEMENT

Substantially all the facts were stipulated (R. 28-52) and were found by the Tax Court as stipulated (R. 54).

The Wabash-Monroe Building Corporation (hereafter referred to as "the corporation") is an Illinois corporation organized August 28, 1925, to erect and operate a building at the corner of Wabash and Monroe Streets, Chicago, Illinois. It has engaged in no other business. On September 1, 1925, it acquired a 99-year lease covering the premises. After demolition of the buildings then standing, it commenced, in January, 1926, construction of a steel frame building, which was completed about June 30, 1927. (R. 54.)

During the construction period, the corporation had no income except interest on funds held to defray construction costs. During this period, it paid out the total amount of $383,805.55, which was charged on its books to building costs. The amount was composed of ground rentals of $115,000 due under the 99-year lease; net interest paid on bonds and notes of $149,261.59; state, real estate, and federal taxes of $86,258.54; and fees of $33,285.42 to disbursing agents and for financial services. (R. 54-55.)

These items were capitalized by the corporation because its accountants were of the view that good commercial accounting practice required that all expenditures should be capitalized during the construction period. Capitalization of the items accords with well-established accounting principles. (R. 55.)

The corporation carried the building on its books as of December 31, 1927, at a cost of $2,491,187.56,

which included the amount of $383,805.55, the 1926-1927 carrying charges, and excluded $14,720.27, the amount by which the building cost was reduced by a revenue agent who examined the corporation's 1927 tax return. This adjustment was accepted by the corporation. (R. 55.)

Depreciation on the building cost per books of $2,491,187.56 was claimed by and allowed to the corporation throughout the period July 1, 1927, to December 31, 1937. In 1938, the cost of the building per books was reduced to $2,486,774.80, as a result of correcting the net cost of a party wall, and from January 1, 1938, to November 30, 1941, depreciation was claimed and allowed to the corporation on this reduced cost. No other adjustments of the building cost, allowable as a basis for depreciation purposes, have been made by the corporation or by the Commissioner. (R. 55-56.)

On November 19, 1941, the corporation's directors declared a distribution to stockholders in the amount of $250,000 "on capital surplus." On November 30, 1941, a cash distribution in that amount was made to the stockholders and was charged on the corporation's books to "capital surplus." Taxpayer Jackson received $112,500 on the 450 shares of stock owned by him in 1941, and taxpayer Farrell received $125,000 on the 500 shares of stock owned by him in 1941 (R. 54, 56).[1]

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[1] Robert O. Farrell died after the hearing and submission of these cases to the Tax Court. The executor of his estate was

The full Tax Court, with no dissents, affirmed the Commissioner's contention that the corporation had properly added these carrying charges to capital account and that it was not required to treat them as expenses during the years when incurred (R. 57-62). This resulted in the sustaining of the deficiency determinations since the parties had stipulated that, if this were so, the corporation possessed sufficient earnings and profits so that the distributions to the taxpayers were taxable dividends (R. 37). The Court of Appeals affirmed the decision of the Tax Court (R. 90-95).

ARGUMENT

1. The decision below is correct. The charges which were incurred by the corporation on unproductive property during the period that improvements were being erected were part of the costs of the property and were not deductible expenses. This being so, the corporation possessed sufficient earnings and profits so that the distributions to the taxpayers qualified as taxable dividends (R. 36-37). Under Article 1561, Treasury Regulations 69 (Appendix, *infra*, pp. 16-17) there is no question but that carrying charges on unproductive property could properly be added to basis at a taxpayer's election. That is what the corporation here actually did and it claimed and was allowed deductions

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substituted as the petitioner in his stead in the Tax Court. (R. 53, fn.) Farrell will be referred to as one of the taxpayers in this brief.

for depreciation on such a basis for a period of fifteen years. It had the right to do so because the Treasury Regulations embody the correct interpretation of Section 202(b)(1) of the Revenue Act of 1926 (Appendix, *infra*, p. 14) which was in effect when these carrying charges were incurred. Those Regulations merely repeated the language of the House Committee Report on Section 202(b) of the 1924 Act, c. 234, 43 Stat. 253, where the statutory language first originated. H. Rep. No. 179, 68th Cong., 1st Sess., pp. 12-13 (1939-1 Cum. Bull. (Part 2) 241, 250). This, in itself, would be conclusive that the Regulations correctly expressed the legislative intent. The conclusion is buttressed by the additional fact that the language of Article 1561 was specifically adopted in statutory form beginning with Section 113 (b)(1)(A) of the Revenue Act of 1932, c. 209, 47 Stat. 169, being applicable to unimproved and unproductive real property, and was continued in all subsequent Acts and in the Internal Revenue Code. Section 130 (a) and (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, broadened Sections 24 (a) and 113 (b)(1)(A) of the Code so that a taxpayer now has an option to capitalize or to deduct such carrying charges on any kind of property. There being no evidence that a change in the existing law as to the right to capitalize carrying charges was contemplated by these steps, Congress could not have indicated more clearly its understanding that the prior Treasury Regulations had accurately re-

flected the congressional purpose. Cf. *Commissioner* v. *Wheeler,* 324 U.S. 542, 547. It seems undeniable that the court below was right in rejecting the taxpayers' contention that the corporation possessed no such election and that these provisions of the Regulations were invalid.

The court below also was correct in holding that the various items involved here were carrying charges on unproductive property which the corporation properly elected to charge to capital account under the Regulations. Article 1561 specifically lists "taxes" as one of the carrying charges which may be added to basis, and the real estate taxes (R. 55) which were here required to be paid while the property was still in an unproductive state were unquestionably within the category of expenditures which could be treated as part of the ultimate cost of the property. While the state and federal taxes on the corporation's bonds, and the state franchise tax (R. 55) are, perhaps, not taxes on the property itself, they were taxes required in connection with carrying the property until brought to a productive state, and were properly chargeable to capital account for that reason. The ground rental under the long-term lease, which the corporation was required to pay during the period in which the building was being constructed, was also the kind of carrying charge within the intent of the statute and the Regulations and, in any event, was properly chargeable to capital account since it was as necessary as any

of the construction costs to the completion of the building. Cf. G.C.M. 11197, XII-1 Cum. Bull. 238 (1933).

The interest on the construction fund (R. 54) which the corporation paid during the period of construction was also one of the costs of acquiring the completed building and could properly be added to basis. The cases cited by the taxpayers (Pet. 13), in an attempt to establish the contrary, are not in point. *Columbia Theatre Co.* v. *Commissioner,* 3 B.T.A. 622; *Spring Valley Water Co.* v. *Commissioner,* 5 B.T.A. 660; *Eastern Rolling Mill Co.* v. *Commissioner,* 5 B.T.A. 663; *Ottawa Park Realty Co.* v. *Commissioner,* 5 B.T.A. 474, and *Oswego & S. R. Co.* v. *Commissioner,* 29 F.2d 487 (C.A. 2d), affirming 9 B.T.A. 904, all involved years prior to 1924 when there was no provision of the statute or Regulations expressly permitting carrying charges to be capitalized, and the decisions there turned on the view that the statutory provisions for the deduction of interest precluded its capitalization. *Queensboro Corp.* v. *Commissioner,* 134 F. 2d 942 (C.A. 2d) (Pet. 13), recognized that when mortgage interest represented a "carrying charge" on unimproved lots, it could be capitalized under Section 113 (b)(1)(A) of the 1934 Act, c. 277, 48 Stat. 680. There, however, the mortgages were not used to acquire the property but were placed on the property after acquisition to raise money for other purposes, and the interest paid was correctly held not to be a capital item.

While the opinion in *Moran* v. *United States,* 19 F. Supp. 557 (C. Cls.) (Pet. 13), is not clear, it would seem likely that the situation there was similar to the *Queensboro* case.

Kentucky Natural Gas Corp. v. *Commissioner,* 47 B.T.A. 330 (Pet. 13), denied the taxpayer the right to capitalize interest charges, not because interest could never be added to capital account, but only because the property there was not unimproved and unproductive real property, and hence was not of the kind covered by the then provisions of the statute and Regulations. Had that not been so, the interest charges would have been permitted to be charged to capital account, as the Board indicated (pp. 340-341) and as the applicable Treasury Regulations expressly provided.

The other financing charges incurred here in connection with the construction loans (R. 55) come within the same category as interest on the loans themselves, and are essentially capital expenditures which may properly appear in the cost basis of the property.

The taxpayers' primary attack on the Regulations is premised on the assumption that, if valid, there would be an adverse effect on the revenue in other situations (Pet. 12-13, 14, 16, 17-18). Such solicitude seems strange when invoked as an argument by taxpayers who, as controlling stockholders and directors, caused the corporation to elect to treat these items as capital expenditures, filing

and signing for fifteen years the corporate income tax returns where depreciation was claimed and allowed on an augmented basis to the direct advantage of the corporation and to their indirect advantage as stockholders (R. 24-25, 34-35, 55-56). Their anxiety is not warranted, however, for Congress, which is the proper authority for establishing taxation policies, has consistently indicated its intention that taxpayers may elect to take the advantages first expressed in the Regulations and then specifically stated in the statutes.

2. Despite the fact that there may be a technical conflict in principle, the situation is not one requiring the intervention of this Court, and further review of this case would not be warranted. In *Central Real Estate Co.* v. *Commissioner,* 47 F. 2d 1036 (C.A. 5th), the court refused to permit a taxpayer to add interest and taxes to the basis of certain property where the taxpayer, by amended returns, had already claimed such items as deductions for prior tax years. Though it was unnecessary to its decision,[2] the court indicated that Article 1561, Treasury Regulations 69, was not a cor-

[2] The property was sold in 1924. Article 1561 of Treasury Regulations 65, promulgated under the 1924 Act, which was applicable in the *Central Real Estate* case, but which was not mentioned by the court, differed from Article 1561 of Treasury Regulations 69, which is involved here and which was the subject of comment in the *Central Real Estate* case, even though not applicable to the tax year in litigation. Regulations 65 did not grant the taxpayer the option which was given by Regulations 69, by subsequent Regulations, and by subsequent statutes, either to capitalize or to expense these items.

rect interpretation of the statute. In doing so, the court conceded that the explanation of Section 202 of the 1924 Act in the House Committee Report, *supra,* would have been persuasive that the Regulations were a proper interpretation of the statute. However, it felt bound to close its eyes to this evidence of congressional intent on the ground that Section 202 was too clear and unambiguous to permit of construction or to allow the use of legislative materials for ascertaining the correct meaning. More recent decisions of this Court demonstrate that the Fifth Circuit was wrong in deliberately ignoring, as irrelevant, such a clear expression by Congress of its intention. *United States* v. *Amer. Trucking Ass'ns,* 310 U.S. 534, 542-544; *United States* v. *Dickerson,* 310 U.S. 554, 561-562; *Harrison* v. *Northern Trust Co.,* 317 U.S. 476. If the *Central Real Estate* case were to arise today, the Fifth Circuit would undoubtedly follow the decisions of this Court respecting the use of legislative materials, and would be quick to recognize that the Commissioner's Regulations carried out the announced intention of Congress. Moreover, the *Central Real Estate* case was decided prior to the time that Congress specifically embodied the provisions of the Regulations in the statute, beginning with the Revenue Act of 1932. If the *Central Real Estate* case were to arise today, it is difficult to believe that the Fifth Circuit, with this added indication of congressional approval,

would still rule that the prior Regulations were at variance with the meaning of the statute.

Finally, since the basic matter has been governed by statute ever since 1932, it is evident that the question of the validity of the prior Regulations can arise only with respect to a limited number of situations. Accordingly, the existence of a conflict, even if it could be believed that the Fifth Circuit would still adhere to its former views, is not one requiring the exercise of this Court's authority.

There is no basis for asserting a conflict with other decisions, and the cases cited by the taxpayer (Pet. 10) are not opposed. *H.M.O. Lumber Co.* v. *United States,* 59 F. 2d 907 (C.A. 6th), similar to other cases already referred to, *supra,* p. 8, involved a taxable year prior to 1924. From what has already been stated about *Queensboro Corp.* v. *Commissioner,* 134 F. 2d 942 (C.A. 2d), and *Moran* v. *United States,* 19 F. Supp. 557 (C. Cls.), it is plain that those cases do not stand in conflict with the decision here. *F.H.E. Oil Co.* v. *Commissioner,* 147 F. 2d 1002, rehearing denied, 149 F. 2d 238, rehearing denied, 150 F. 2d 857 (C.A. 5th) (Pet. 10-11), does not merit discussion since it has nothing to do with the situation here or with the existence of a conflict.

CONCLUSION

The petition for writs of certiorari should be denied.

Respectfully submitted,

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July, 1949.

APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.

(b) In computing the amount of gain or loss under subdivision (a)—

(1) Proper adjustment shall be made for any expenditure or item of loss properly chargeable to capital account, and

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SEC. 212. * * *

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

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INTERNAL REVENUE CODE:

SEC. 115. DISTRIBUTION BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(d) [As amended by Section 214 (b), Revenue Act of 1939, c. 247, 53 Stat. 862] *Other Distributions from Capital.*—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of

such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f) (1), is not treated as a dividend, whether or not otherwise a dividend.

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(26 U.S.C. 1946 ed., Sec. 115.)

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

ART. 23. *Bases of computation.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. (See sections 200 (d) and 213 (a).) * * *

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ART. 1561. *Determination of the amount of gain or loss.*—Section 202 sets forth the rules for the determination of the amount of gain or loss from the sale or other disposition of property. In general, the gain

from the sale or other disposition of property is the excess of the amount realized therefrom over the cost or other basis provided in section 204 and articles 1591-1603, and the loss is the excess of such cost or other basis over the amount realized. Whether gain or loss from a sale or exchange shall be recognized, and if so, the extent to which it is to be recognized for the purpose of income taxation must be determined under the provisions of section 203 and articles 1571-1580.

The amount realized from the sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. In computing the amount of gain or loss, however, the cost or other basis of the property must be increased by the cost of capital improvements and betterments made to the property since the basic date, and by carrying charges, such as taxes on unproductive property. Where the taxpayer has elected to deduct carrying charges in computing net income, or used such charges in determining his liability for filing returns of income for prior years the cost or other basis may not be increased by such items in computing the gain or loss from the subsequent sale of the property. The cost or other basis of the property must then be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property, whether or not such deductions were claimed by the taxpayer or formally allowed. * * *

* * * * *

Treasury Regulations 103, promulgated under the Internal Revenue Code:

> SEC. 19.41-2. *Bases of computation and changes in accounting methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * *
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> SEC. 19.115-3 [as amended by T.D. 5059, 1941-2 Cum. Bull. 125]. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall,

with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204(b)(5) and which is segregated accordingly in the unearned premium reserve. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.

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